

Market Review and Outlook—April 6, 2017

Disregard the Noise While the newspapers have been busy this past quarter, with the inauguration, judicially blocked immigration orders, and the failure to pass a big health care bill, the stock markets and bond markets have seemed to take little notice. If anything, stocks have benefited from the reduced expectations of the Trump Administration. Why? Many of President Trump’s appointments and executive orders are designed to directly benefit corporate America, and over time boost their profits. Beneath the noise, the past quarter has brought several reasons for markets to rise.

Furthermore, investors don’t like surprises, or sharp changes. In January the talk was of big changes; in April, the outlook is less grandiose. Sometimes there is upside to gridlock; sometimes, less is more.

Boring Oil and US Dollar In the past quarter the US dollar fell 0.8%. Oil fell 3.5%, yet remains up 33.9% higher than a year ago. Stability in both markets is positive. A stable dollar enables foreign stocks to trade based on their merits, not on currency moves. The table below shows how beneficial this has been. Oil prices stabilizing above the \$50 per barrel level enables the S&P 500 earnings to regularly rise, as energy companies heal their profits to recover from the oil slump of early 2016.

Interest Rates and the Fed The Fed raised overnight rates ¼% in March, and is expected to do this again two or three times later this year. Bond markets took this in stride, as this rise is the most anticipated in generations, and expected to be one of the most gradual. During the quarter longer-term quality bonds outperformed shorter-term ones. Opportunity bonds outperformed quality bonds.

As It Should Be The chart below looks ‘normal’ for the past quarter. Bonds outperform cash, US stocks outperform bonds, and foreign stocks outperform US stocks. The long-term results are just a bit different, as the biggest oddball result is from foreign stocks, which have lagged for years.

Rebalance, Rebalance The chart below shows strong gains in many stock categories. This provides another good opportunity to seal in profits, which is built into the rebalancing process. With one-year gains at 10% and greater, it is important that investors work to prevent their stock exposure from creeping too high.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.07%	+0.16%	+0.06%	+0.04%	+0.75%
Intermediate Term Bond	+1.06%	+1.78%	+2.44%	+2.57%	+4.09%
Intermediate Muni Bond	+1.30%	-0.32%	+2.71%	+2.58%	+3.49%
Large-Cap Stock	+5.55%	+15.88%	+8.04%	+11.68%	+6.48%
Mid-Cap Stock	+4.19%	+17.14%	+6.29%	+11.48%	+6.71%
Small-Cap Stock	+1.75%	+21.75%	+5.89%	+11.17%	+6.56%
Foreign Large-Cap Stock	+7.77%	+10.64%	+0.30%	+4.92%	+0.88%
Natural Resources	+0.50%	+19.85%	-4.82%	-0.72%	+0.59%
Real Estate	+0.94%	+2.99%	+8.92%	+8.79%	+3.94%
Technology	+12.54%	+26.75%	+12.80%	+13.21%	+9.60%
Moderate Allocation (60% stocks)	+3.85%	+10.65%	+4.54%	+7.14%	+5.12%

The data in this table comes from Morningstar and is as of March 31, 2017.

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The **US economy** remains strong, with no strong signs of danger. The Conference Board maintains a Leading Economic Indicator (LEI), which is at the highest level it has reached in a decade. This isn't a sign that we are at a top. As an index which forecasts future economic growth, its rising is good, and typically precedes further good times. When it falls, and continues to fall for six months or more, then the economy is likely to falter, and markets tip. Like the LEI, US consumer confidence is similarly strong, and has been for over two years. It, too, typically falls **before** stock market declines.

Global economic growth similarly looks solid. Of 23 countries and regions, 20 post positive manufacturing outlooks, including the US, Great Britain, Europe, China, and India. Only Greece, South Korea, and Brazil show concern. This isn't too surprising, as interest rates are extremely low across the globe, so companies can operate cheaper than normal, and, additionally, investors need to invest in stocks for attractive potential returns. Inflation similarly is low, which also helps companies operate profitably.

Stocks are not cheap in the US, but given continued economic growth, strong profit growth, low interest rates and inflation, and reduced regulatory burdens announced by the Trump Administration, prices are currently well-justified. Despite recent strength, foreign stocks remain very attractive, much cheaper than US stocks. With the US dollar stabilized, investors are keeping more of their foreign profits. Europe unemployment still has much further to fall, and this is very good for their economic growth (limited new workers is one of the constraints for long-term US economic growth). Europe is also seeing very solid loan demand. Asia is doing well, with Taiwan and India doing quite well recently. Emerging markets are faring well. In fact, emerging markets in Asia, Latin America, Europe/Middle East/Africa all have enjoyed strong earnings growth over the past several quarters.

The US economy is being discharged from the hospital, as the **Federal Reserve Bank** has begun to remove the life support, by beginning to return short-term interest rates to normal levels. This will take years, and is expected to be very gradual. Additionally, the Fed will unwind its huge inventory of bonds, and do so in a way that does not cause the bond market to crash. Hopefully they are up to the task, as central banks across the globe hope to be in a position to follow the Fed's lead in future years, to slowly unwind their support programs.

We prefer stocks to bonds more than normal, and are setting stock targets to 102% of their long-term target levels. We have no other changes to our stock strategy from January. We are maintaining our 56/44% balance of US/foreign stocks, our 70/20/10 split of large/mid/small-cap stocks. We are neither favoring growth nor value stocks at this time. We have a small lean to tech stocks and a larger lean to health-care stocks. We continue a 4% allocation to real estate and another 4% to natural resources. For foreign stocks we focus 20% on emerging markets, 17% to smaller stocks in larger countries, 18% to Europe specifically, and the other 45% to foreign-based multi-national large companies.

Our bond strategy is similarly little changed from January. We still have a 65/35% quality/opportunity balance, with quality invested 3/27/30/5% cash/short-term/intermediate-term/inflation-linked bonds. Opportunity bonds for lower-tax bracket clients is 10/10/15% high-yield/multi-sector/bank loan, while higher bracket clients get 20/5/10 high-yield/multi-sector/bank loan.

We feel that stocks are 'safe enough' at this time, and that while bonds face a headwind, it is just a gentle breeze, not gale-force. We are pleased that foreign stocks (finally) are leading the gains, and wouldn't be surprised if this continues for quite some time. There is always a chance of a short-term surprise, but this is one reason that we introduced our **Drop & Give Me Five™** program.

We recommend that you create a written **Investment Policy Statement**, read it, and follow it. Write it in calm times, and follow it in difficult times. If you don't have one yet, now is an excellent time to put it together.